Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Alpert	Analyst:	LuAnna Hass	Bill Number:	SB 1445
Related Bills:	See Legislative History	Telephone:	845-7478	Introduced Date:	February 15, 2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Settlement of Tax Disputes

SUMMARY

This Franchise Tax Board (FTB) sponsored bill would make two enhancements to FTB's authority to settle civil tax disputes to allow:

1. the Executive Officer and Chief Counsel to approve any settlement up to $7,500 and index that amount in future years to reflect inflation, and
2. tax years to be completely resolved through a settlement agreement

Each provision will be discussed separately.

PURPOSE OF THE BILL

The purpose of this bill is to allow more taxpayers to qualify for the expedited processing offered to smaller settlements and to allow taxpayers to resolve a tax year completely to protect against future audits.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative January 1, 2003, and apply to all settlements approved on or after that date.

POSITION

Pending.

ANALYSIS

See Attachment A for definitions and background information about FTB's settlement authority.

FEDERAL/STATE LAW

Federal tax law permits a taxpayer to file a petition with the Tax Court for a redetermination of a deficiency assessment. In addition, federal law contains provisions that are similar to California law that allow a taxpayer to resolve tax disputes through a closing agreement or to reduce an otherwise payable amount through an offer-in-compromise (OIC). Unlike California, the Internal Revenue Service (IRS) does not have separate statutory authority for settlement agreements. The IRS also settles disputes internally in conjunction with its appeals office.

Board Position:			Department Director	Date
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For state purposes, FTB is authorized to enter into closing agreements with any person with respect to any tax, interest, penalty, or addition to tax. Closing agreements are used to conclude matters where the state determines it would be beneficial to both the state and taxpayer to close a tax issue or tax year permanently. A closing agreement approved by the three-member Board is conclusive and cannot be reopened or modified, set aside, or disregarded.

FTB also has express statutory authority to settle tax matters in dispute that are the subject of protests, appeals, or refund claims. The settlement must be consistent with a reasonable evaluation of the costs and risks associated with litigating these matters.

The Executive Officer or Chief Counsel of the FTB has the authority to recommend settlements to the three-member Board for approval or disapproval. Before a recommendation can be submitted to the three-member Board, the Attorney General must review the recommendation and advise in writing whether the recommendation is reasonable from an overall perspective. The authority of the three-member Board with regard to the settlement is limited to actual approval or disapproval. The Board members are prohibited from participating in negotiating the settlement.

To expedite the processing of settlements, FTB's Executive Officer and Chief Counsel may approve any settlement involving a reduction of tax or penalties that is $5,000 or less. The Executive Officer notifies the Board members of the approved settlement.

Except in the case of fraud or misrepresentation of facts, all settlements are final and non-appealable.

1. INCREASE SMALL CASE THRESHOLD FROM $5,000 TO $7,500

THIS BILL

This bill would increase the Executive Officer's and Chief Counsel's settlement threshold to $7,500. Thereafter, the threshold would be indexed annually to reflect inflation.

IMPLEMENTATION CONSIDERATIONS

This provision of the bill could be easily implemented by the department and would improve the department's ability to administer laws relating to settlements.

FISCAL IMPACT

This provision of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Discussion

This provision of the bill would accelerate the completion of disputed tax issues and would not change negotiated final determinations or the timing of taxpayer payments. Generally, taxpayers must make payment within the nine-month settlement period. Expediting the resolution process could result in the department issuing refunds sooner than otherwise by a few months. The revenue effects would be inconsequential.

2. FINALITY OF SETTLEMENTS/CLOSING AGREEMENTS

THIS BILL

This bill would expand the scope of settlement agreements to be the same as a closing agreement. Thus, this bill would allow the resolution of all tax matters in a tax year, instead of just the tax matters in dispute. In addition, the settlement agreement would have the same degree of finality as a closing agreement. Adjustments due to a federal Revenue Agent Report (RAR) would be excepted from the settlement and closing of a tax year. In addition, any other issue that FTB or the taxpayer would like to except from the closing of the tax year would be allowed as part of the settlement agreement.

IMPLEMENTATION CONSIDERATIONS

This provision of the bill would allow the department to combine a settlement and closing agreement into one document, which would improve the department's ability to administer laws relating to settlements. Since the department currently has statutory authority to develop separate settlement and closing agreements, the department could easily implement this provision of the bill.

FISCAL IMPACT

This provision of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

This provision of the bill would not impact the state's income tax revenue.

ARGUMENTS/POLICY CONCERNS

Taxpayers and their representatives have expressed an interest in having finality to the tax years that are subject to a settlement. This bill would give the Settlement Bureau within FTB express authority to resolve completely those tax years that are subject to a settlement. In addition, this bill would give the Settlement Bureau broader authority to close any other matter in tax years that may not yet be in dispute.

Closing agreements completely resolve or "close" tax years, which protects the taxpayer from future audits on those same tax years. Since settlement agreements do not completely resolve or "close" a tax year, the Settlement Bureau has increasingly found it necessary, while negotiating administrative settlements, to be forced to use a closing agreement instead of a settlement agreement in those situations where a taxpayer expresses a desire to resolve a tax year completely in order to be protected against future audits of other issues for the same year. Additionally, taxpayers in the settlement process have increasingly expressed interest in closing years not subject to dispute at the time of settlement. This bill would benefit taxpayers because there would be finality to the settled tax years, with an exception for RAR's because they often occur after settlement has been completed, and would also benefit the department by permitting the Settlement Bureau broader latitude in the settlement process.

LEGISLATIVE HISTORY

AB 1823 (Alpert, Ch. 868, St. 1993) extended FTB's authority to settle tax disputes in existence after July 1, 1993. AB 3308 (Takasugi, Ch. 138, St. 1994) made FTB’s settlement authority permanent following the existing basic procedures and processes, except those cases involving tax reductions of $5,000 or less are approved by the Executive Officer and Chief Counsel instead of the FTB, without AG review.

OTHER STATES’ INFORMATION

A review of *Florida, Illinois, Massachusetts, Michigan, Minnesota, New York*, and *Texas* laws found tax settlement programs in two states.

- *Texas.* The Comptroller is authorized to settle claims for tax, penalties, or interest before the taxpayer files a protest of a deficiency assessment if the total cost of collection would exceed the amount due and the amount due was not more than $1,000. The Comptroller also may settle claims for refund of tax, penalty, or interest if the cost of defending a denial exceeds the amount claimed.
- *Massachusetts.* Settlements for tax, penalties, and interest may be authorized with the approval of the commissioner and two deputy commissioners. Any settlement that is at least $20,000 less than the total amount due must be submitted to the Attorney General for review.

The laws of these states were reviewed because their tax laws are similar to California’s tax laws.

LEGISLATIVE STAFF CONTACT

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Attachment A

DEFINITIONS AND BACKGROUND ON THE AUDIT PROCESS AS IT RELATES TO FTB's SETTLEMENT AUTHORITY

Deficiency Assessments

During an audit, FTB considers all facts and applicable laws when proposing tax deficiency assessments. To determine whether income, losses, deductions, credits, or gains are correctly claimed on a California tax return, FTB uses various information resources, including Internal Revenue Service (IRS) audits and information supplied by the taxpayer. The department reviews the taxpayer's California return and proposes any appropriate deficiency assessments.

Taxpayers may protest the proposed assessment by filing a written protest with FTB. Department staff then reviews the protest, conducts any requested hearings, and mails the taxpayer a Notice of Action based on the results of the review. At this point in the process, both the "audit" and the "protest" are concluded.

The taxpayer may then appeal the result of the department's Notice of Action to the Board of Equalization (BOE). The BOE will then rule on the appeal, and if the taxpayer succeeds at this level, the proposed deficiency assessment is withdrawn and the decision is final. If the taxpayer loses the appeal, the taxpayer must pay the deficiency assessment, if they have not already done so, and may file a refund suit in Superior Court.

A settlement may be initiated during the protest, appeal, or when a claim for refund has been requested and the department will then consider the costs and risks of litigating the matter when considering a settlement.

Definitions

The following definitions should be used as general guidelines in understanding FTB's authority to "settle" tax matters:

- *Dispute*. The taxpayer and FTB disagree with respect to a tax matter. A dispute may involve tax, penalty, addition to tax, or interest. A dispute may involve a disagreement about the correctness of a proposed assessment or whether the taxpayer is entitled to a refund.
- *Settlement*. The conclusion of a tax dispute after reviewing the facts and pertinent law. The costs and risks of litigating the matter are taken into consideration when considering a settlement.
- *Compromise*. FTB accepts an amount that is less than the total amount owed on the taxpayer's delinquent account as full payment of the debt. A compromise is not a "settlement" and does not involve a "dispute."
- *Closing Agreement*. A statutorily authorized contract between FTB and the taxpayer that resolves issues with respect to any tax, interest, penalty, or addition to tax. Generally, closing agreements are used to conclude matters where it is in the best interest of the State to close a tax issue or tax year permanently.